DEPARTMENT OF STATE REVENUE
SUPPLEMENTAL LETTER OF FINDINGS NUMBER: 06-0415
Income Tax
For The Tax Years 2001-2003

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ISSUES

I. **Financial Institutions Tax –** Forced Combination.

Authority: IC § 6-5.5-1-17(d); IC § 6-8.1-5-1(c).

The Taxpayer contends that one of its subsidiaries is subject to the financial institutions tax rather than the adjusted gross income tax.

II. **Adjusted Gross Income Tax –** Forced Combination.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1(c).

The Taxpayer protests the forced combination for adjusted gross income tax purposes.

III. **Tax Administration** – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2(b).

The Taxpayer protests the imposition of the negligence penalty.

STATEMENT OF FACTS

The Taxpayer is a trucking company. After an audit, the Indiana Department of Revenue (Department) assessed additional adjusted gross income tax, penalty, and interest. The Department determined that the Taxpayer should have been combined with a corporate affiliate, "Corporation A." The Taxpayer created Corporation A to purchase the Taxpayer's accounts receivables at a discounted price. Corporation A collected the account receivables and used them as securitization for commercial paper in the short term market. The yield on the commercial paper was considered a financing cost and included interest expense in the consolidated statement of operations. Corporation A loaned funds to the Taxpayer as an offsetting asset. The Taxpayer protested and a hearing was held. A Letter of Findings was issued on July 25, 2007. A rehearing was requested. The rehearing was held on August 8, 2007. This Supplemental Letter of Findings results.

ISSUES

I. Financial Institutions Tax – Forced Combination.

DISCUSSION

Tax assessments are presumed to be accurate. IC § 6-8.1-5-1(c). The Taxpayer bears the burden of proving that any assessment is incorrect. *Id.*

The Taxpayer argued that Corporation A was a financial institution and subject to the financial institutions tax rather than the adjusted gross income tax, because it engaged in the acquiring, servicing, and selling of unsecured consumer loans. Therefore, Corporation A could not be combined with the Taxpayer for adjusted gross income tax purposes. The Department did not consider Corporation A to be a financial institution for financial institutions tax purposes.

The Taxpayer argued that Corporation A was a financial institution because it engaged in the acquiring, servicing, and selling of loans or extensions of credit – the accounts receivables – which Corporation A purchased from the Taxpayer. To be determined, therefore, is whether or not accounts receivable are loans or extensions of credit as contemplated by the statute and whether Corporation A was a financial institution subject to the financial institutions tax.

The Taxpayer submitted a Revenue Ruling issued August 1, 2001 in support of its contention that the income of Corporation A, a "factoring corporation," is subject to the financial institutions tax. It is not clear, however, that the facts in that situation are identical to the Taxpayer's situation. Further, the Revenue Ruling is over six years old. Therefore, it no longer has precedential value. The Taxpayer's situation must be considered on its own merits.

To be considered a financial institution subject to the financial institution's tax, Corporation A must receive at least eighty percent of its gross income from one of the activities listed at IC § 6-5.5-1-17(d) as follows:

> (2) For any other corporation described in subsection (a)(4), all of the corporation's business activities if eighty percent (80 [percent]) or more of the corporation's gross income, excluding extraordinary income, is derived from one (1) or more of the following activities:
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> (A) Making, acquiring, selling, or servicing loans or extensions of credit. For the purpose of this subdivision, loans and extensions of credit include:
> - (i) secured or unsecured consumer loans;
> - (ii) installment obligations;
> - (iii) mortgage or other secured loans on real estate or tangible personal property;
> - (iv) credit card loans;

(v) secured and unsecured commercial loans of any type;
(vi) letters of credit and acceptance of drafts;
(vii) loans arising in factoring;
(viii) any other transactions with a comparable economic effect.

(B) Leasing or acting as an agent, broker, or advisor in connection with leasing real and personal property that is the economic equivalent of the extension of credit if the transaction is not treated as a lease for federal income tax purposes.

(C) Operating a credit card, debit card, charge card, or similar business.

As used in this subdivision, "gross income" includes income from interest, fees, penalties, a market discount or other type of discount, rental income, the gain on a sale of intangible or other property evidencing a loan or extension of credit, and dividends or other income received as a means of furthering the activities set out in this subdivision.

In the Taxpayer's situation, it sells services to a customer. The Taxpayer invoices the customer for the service. The customer has a period of time, such as thirty days, to pay the cost of the service to the Taxpayer. At the time of the sale, the Taxpayer enters the money to be received from the sale on its books. The Taxpayer has created an account receivable. The Taxpayer then sells these accounts receivable at a steep discount to Corporation A for collection. The Taxpayer argues that this account receivable qualifies as the sort of instrument handled by a financial institution because the customer receives an item of tangible personal property or service and has thirty days before payment is due.

The Taxpayer's accounts receivable are not the equivalent of a loan or extension of credit as were the leases in the CAT case. The Taxpayer does not loan money to customers or service loans. There are no loan documents which specify regular payments of principal and interest. The Taxpayer does not sell and service investment vehicles. The Taxpayer does not provide mortgages. The Taxpayer does not offer and service extensions of credit such as limits up to which a customer can borrow money without prior approval like a bank. The Taxpayer does not offer and service credit cards. The Taxpayer merely sets up typical account receivables – essentially thirty day grace periods – before payment for a good or service is due. Corporation A purchases the Taxpayer's account receivables at a discount and collects them. This activity does not constitute transacting financial business subject to the financial institutions tax.

In the Taxpayer's accounts receivable, the customer has a debt which it owes to the Taxpayer for the purchase of a service. If it were a consumer or commercial loan, the Taxpayer would have given the customer money or a credit to purchase items. The Taxpayer would also charge interest. The account receivables established by the Taxpayer are not governed by truth-in-lending statutes and regulations as are consumer loans. The Taxpayer is not loaning money to its customers. Rather, the Taxpayer is delivering product to its customers and then allowing a short grace period before payment

for the product is due. This does not constitute an unsecured consumer or commercial loan. Since there is no loan to the customer, there is no loan arising in factoring.

The Taxpayer also argued that Corporation A qualified as a financial institution because it borrowed money in the open market and loaned that money to the affiliated corporations. In reality, however, Corporation A merely passed the amounts of money it borrowed through to the affiliated corporations. An actual loan from Corporation A to other corporations and Corporation A did not service the nonexistent loan.

Corporation A does not receive at least eighty percent of its income from any of the transactions enumerated in IC § 6-5.5-1-17(d). Therefore, Corporation A is subject to adjusted gross income tax rather than financial institutions tax.

FINDING

The Taxpayer's protest is respectfully denied.

II. Adjusted Gross Income Tax – Forced Combination.

DISCUSSION

The Taxpayer protests the forced combination of itself and Corporation A. The Taxpayer argues that the Department has the burden of proving that it properly combined the corporations for adjusted gross income tax purposes. The Taxpayer errs in this allegation. Taxpayers have the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c).

The Department combined the Taxpayer and its related corporations into combined Indiana returns for the tax period 2001 - 2003 pursuant to the provisions of IC § 6-3-2-2 as follows:

> (l) If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any of the taxpayer's business activity, if reasonable:
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> (1) separate accounting:
> (2) the exclusion of any one (1) or more of the factors:
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.
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> (m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order

> to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

When a taxpayer's method of filing individual Indiana adjusted gross income tax returns for related corporations distorts the Indiana income or expenses, the Department may require that the related taxpayers file a combined return. The purpose of the forced combined return would be to fairly reflect the taxpayer and related corporations' actual Indiana income and expenses.

In this case, the Taxpayer's filing method distorted the Taxpayer's Indiana income and expenses. By selling its accounts receivables at a discount, the Taxpayer created a substantial artificial loss unrelated to its Indiana activities. The Taxpayer's utilization of this artificial loss distorted the Taxpayer's Indiana income and expenses to such an extent, that the individual Indiana adjusted gross income tax return did not fairly reflect the Taxpayer's Indiana income. Corporation A's passing through of loans to the Taxpayer and associated interest expense deductions also distorted the Taxpayer's Indiana adjusted gross income. Due to these distortions, the Indiana adjusted gross income tax return did not fairly reflect the Taxpayer's Indiana income. The Department had no option but to force the related corporations to file a combined return in order to fairly reflect the Taxpayer's Indiana income. The Taxpayer has not met its burden of demonstrating that the Department erred by requiring the filing of combined returns.

FINDING

The Taxpayer's protest is respectfully denied.

III. Tax Administration – Negligence Penalty.

DISCUSSION

The Taxpayer protested the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation 45 IAC 15-11-2(b) clarifies the standard for the imposition of the negligence penalty as follows:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at 45 IAC 15-11-2(c) as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
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> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

The Taxpayer failed to sustain its burden of proving that the underpayment of adjusted gross income tax resulted from reasonable cause. The penalty was properly imposed.

Finding

The Taxpayer's protest to the imposition of penalty is respectfully denied.

KMA/LS/DK – September 28, 2007